

Message Text

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USOECD ALSO FOR EMBASSY

USEEC

E.O. 11652: N/A
TAGS: ECON, EFIN, CA
SUBJECT: OUTLOOK FOR CANADIAN ECONOMY IN 1978

REFS: A. OTTAWA 7979 OF 1 SEP, 1977, B. OTTAWA 9569 OF
5 NOV, 1977

1. SUMMARY. EMBASSY HAS REVISED DOWNWARD 1978 FORECAST
FOR CANADIAN REAL GNP TO ABOUT FOUR PERCENT GROWTH FROM
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4.5 PERCENT THREE MONTHS AGO (REF A.) MAIN FACTOR
INDUCING DOWNWARD REVISION IS SUBSTANTIALLY WEAKER OUTLOOK
FOR PRIVATE FIXED INVESTMENT THAN PREVIOUSLY FORECAST.
MAIN FORCES OF GROWTH IN 1978 WILL BE PRIVATE CONSUMPTION
SPENDING AND IMPROVEMENT OF REAL FOREIGN BALANCE.
INFLATION RATE WILL REMAIN HIGH, ALTHOUGH TRENDING DOWNWARD
DURING THE YEAR; CONSUMER PRICES WILL BE UP YEAR OVER

YEAR AT LEAST 7.5 PERCENT AND THE GNP DEFLATOR, 6.5 PERCENT. UNEMPLOYMENT IS UNLIKELY TO FALL AND COULD WELL RISE FOR A TIME FROM PRESENT LEVEL OF 8.5 PERCENT. CURRENT ACCOUNT IS EXPECTED TO SHOW LITTLE CHANGE FROM DEFICIT OF ABOUT CDOLLS 4.4 BILLION THIS YEAR, AS GROWING MERCHANDISE TRADE SURPLUS IS BALANCED BY GROWTH OF SERVICE DEFICIT. END SUMMARY.

2. SETTING. THE CANADIAN RECOVERY RAN OUT OF STEAM IN 1977. A STRONG FIRST QUARTER FOLLOWING A WEAK SECOND HALF IN 1976 LED SOME TO BELIEVE THAT THE ECONOMY HAD TURNED AROUND INTO A STRONG EXPANSIONARY PHASE, BUT NEGATIVE REAL GNP GROWTH IN THE SECOND QUARTER ENDED THAT HOPE. TOTAL REAL GNP GROWTH IN 1977 WILL BE ONLY ABOUT 2.4 PERCENT OVER 1976, WHEN THE ECONOMY EXPANDED 4.9 PERCENT. UNEMPLOYMENT ROSE IN 1977 TO FINISH THE YEAR AT 8.5 PERCENT. INFLATION, FED BY HIGHER FOOD PRICES, WAS 9.1 PERCENT HIGHER THAN A YEAR EARLIER, WHILE NON-FOOD PRICES DECELERATED. THE CURRENT ACCOUNT IN 1977 MEASURED IN CANADIAN DOLLARS DETERIORATED FROM 4.2 BILLION TO ABOUT 4.4 BILLION. DOMESTIC DEMAND REMAINS WEAK. STRONG FOREIGN DEMAND, HELPED BY GOOD U.S. ECONOMIC GROWTH AND A DEPRECIATING CANADIAN DOLLAR, WAS THE STRONGEST COMPONENT OF TOTAL DEMAND AS THE MERCHANDISE EXPORTS SURPLUS MORE THAN DOUBLED FROM THE 1.1 BILLION SURPLUS RECORDED IN 1976. LITTLE STIMULUS CAME FROM GOVERNMENT LIMITED OFFICIAL USE

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BECAUSE OF FEAR OF INFLATION, PLUS CONCERN OVER THE SIZE OF BUDGET AND CURRENT ACCOUNT DEFICITS, AND THE DEPRECIATING CANADIAN DOLLAR. THE FEDERAL BUDGET HAS BEEN LIMITED LARGELY TO REALLOCATING RESOURCES INTO MORE DIRECT JOB CREATION PROGRAMS, FURTHER INVESTMENT INCENTIVES, AND PROMOTING THE USE OF DOMESTIC EQUITY MARKETS RATHER THAN FOREIGN DEBT MARKETS. A GRADUALIST MONETARY POLICY HAS SOUGHT TO MODERATE THE GROWTH OF AGGREGATES TO REDUCE INFLATION WHILE ACCOMMODATING GROWTH AT OR ABOVE CAPACITY. EXCHANGE RATE POLICY HAS SOUGHT TO STEM DISORDERLY CONDITIONS AND DEPRECIATION BY "GIVING THE MARKET A LEAD" THROUGH ANNOUNCEMENT IN OCTOBER OF A STANDBY CREDIT AND PROBABLY SOMEWHAT MORE ACTIVE INTERVENTION IN AN EFFORT --SO FAR SUCCESSFUL--TO RESTORE MORE ORDERLY MARKET CONDITIONS WITH THE RESULT THAT THE CANADIAN DOLLAR RATE HAS BEEN STABILIZED WITH RESPECT TO THE U.S. DOLLAR (BUT NOT OTHER CURRENCIES). ALTHOUGH LEVEL AT BEGINNING OF YEAR, INTEREST RATES HAVE MOVED UP RECENTLY, REFLECTING INCREASES IN U.S. RATES. ABSOLUTE LEVELS OF AUTONOMOUS FOREIGN BORROWING CONTINUE AT HIGH LEVELS, ALTHOUGH LOWER THAN THE HISTORIC HIGHS IN 1976, IN PART DUE TO LOWER INTEREST RATE DIFFERENTIALS WITH THE U.S. AND

INCREASED AWARENESS, ESPECIALLY BY PROVINCIAL GOVERNMENTS,
OF THE NEED TO IMPROVE THEIR BALANCE SHEETS. THE BASIC
BALANCE IN 1977 WAS IN APPROXIMATE EQUILIBRIUM, DOWN FROM
THE LARGE SURPLUS IN 1976.

3. CONSUMPTION. WAGE INCREASES AWARDED IN NEGOTIATED CON-
TRACTS DECELERATED IN COURSE OF 1977. CONTRACTS NEGOTIATED
IN THIRD QUARTER OF LAST YEAR PROVIDED FOR FIRST YEAR
INCREASES OF 7.6 PERCENT COMPARED WITH NEGOTIATED INCREASES
OF NEARLY 10.5 PERCENT IN 1976. SINCE WAGE INCREASES HAVE
DECELERATED AT THE MARGIN, INCREASE IN AVERAGE EARNINGS
HAS FALLEN, BUT HAS REMAINED ABOVE WAGE INCREASES. AVERAGE
WEEKLY EARNINGS REGISTERED TWELVE MONTH INCREASE OF 10 PER-
CENT IN SEPTEMBER 1977, DOWN FROM 12.3 PERCENT RISE IN
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1976. MODERATION OF WAGE INCREASES PRIMARILY REFLECTED WEAK LABOR DEMAND, BUT AIB CONTROLS MAY ALSO HAVE BEEN A RESTRAINING FACTOR.

4. AS PART OF MINI-BUDGET ANNOUNCED OCTOBER 20, GOC INDICATED THAT THE BASIC CEILING FOR NOMINAL COMPENSATION INCREASES UNDER COLLECTIVE CONTRACTS SUBJECT TO CONTROLS WOULD BE REDUCED TO 6 PERCENT AND THAT CONTROLS WILL END FOR CONTRACTS WHICH EXPIRE AFTER APRIL 14 OF THIS YEAR. HOWEVER, BASIC COMPENSATION CEILING, FACT THAT TIMING OF PHASEOUT WILL LEAVE SUBSTANTIAL PROPORTION OF LABOR UNDER CONTROLS FOR ALL OF 1978, AND WEAK LABOR MARKET, ALL IMPLY THAT COMPENSATION RATES AND AVERAGE EARNINGS WILL CONTINUE LIMITED OFFICIAL USE

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TO SHOW SMALLER INCREASES DURING THIS YEAR. CONSEQUENTLY, INCREASES IN AVERAGE EARNINGS SHOULD DECLINE FROM 10 PERCENT LEVEL AT END OF 1977 TO ABOUT 8 PERCENT ON AVERAGE NEXT YEAR. SINCE CPI LIKELY TO RISE BY ABOUT 7.5 PERCENT (SEE PARA 21 BELOW) REAL AVERAGE EARNINGS SHOULD INCREASE BY ABOUT ONLY 0.5 PERCENT.

5. ESTIMATED EMPLOYMENT GROWTH OF 2 - 2.5 PERCENT IN 1978 (SEE PARA 27 BELOW) COMPARED WITH 0.5 PERCENT IN REAL AVERAGE EARNINGS WOULD PRODUCE 2.5 PERCENT - 3 PERCENT INCREASE IN REAL LABOR INCOME. INCREASE IN REAL DISPOSABLE LABOR INCOME SHOULD BE SOMEWHAT LARGER THAN THAT OF REAL INCOME DUE TO CDOLS 700 IN TAX CUTS (VIA LOWER WITHOLDING) PLANNED FOR JANUARY AND FEBRUARY. IN ADDITION, OPERATION OF TAX INDEXATION SYSTEM COULD ACT TO REDUCE ELASTICITY OF PERSONAL TAX REVENUES WITH RESPECT TO NOMINAL GNP IN 1978. (DUE TO ONE YEAR LAG IN CALCULATION OF INDEXATION FACTOR, DECELERATION OF INFLATION RATE IN A GIVEN YEAR TENDS TO LOWER DEGREE TO WHICH GROWTH OF NOMINAL INCOME EXCEEDS INDEXATION FACTOR WITH RESULT THAT ELASTICITY OF TAX REVENUES WITH RESPECT TO NOMINAL INCOME FALLS; THIS SHOULD BE THE CASE IN 1978). ACCORDINGLY, INCREASE IN REAL DISPOSABLE LABOR INCOME COULD BE IN EXCESS OF 3 PERCENT THIS YEAR. HOWEVER, NET FARM RECEIPTS ARE LIKELY TO FALL AGAIN IN 1978, WHILE INCREASES IN ENTREPRENEURIAL AND PROFESSIONAL INCOMES CAN BE EXPECTED AT LEAST TO KEEP PACE WITH INFLATION RATE. AS A RESULT, EMBASSY ESTIMATES REAL PERSONAL DISPOSABLE INCOME IN 1978 SHOULD INCREASE BY ABOUT 3 - 3.5 PERCENT.

6. RATIO OF SAVINGS TO DISPOSABLE INCOME AVERAGED 8.9 PERCENT BETWEEN 1971 AND 1976. IN SECOND QUARTER OF 1977, SAVINGS RATE INCREASED TO 11.1 PERCENT, LARGELY TO A LAG

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IN SPENDING OF TAX REFUNDS, AND SUBSEQUENTLY DROPPED BACK TO 9.6 PERCENT IN THIRD QUARTER. RECENT TRENDS IN REAL INCOME AND IN RETAIL SALES INDICATE THAT SAVINGS RATIO MAY HAVE DECLINED FURTHER IN FOURTH QUARTER. SLOW GROWTH OF REAL INCOMES THIS YEAR COMBINED WITH SOME IMPROVEMENT IN PRICE AND EMPLOYMENT PERFORMANCE WOULD BE CONDUCTIVE TO A DROP IN SAVINGS RATIO. THUS, DECLINE IN SAVINGS RATIO TO 9 PERCENT COULD WELL MATERIALIZE, GENERATING GROWTH IN REAL CONSUMPTION OF ABOUT 3.5 - 4 PERCENT.

7. PRIVATE INVESTMENT. PRIVATE INVESTMENT WILL SHOW LITTLE OR NO GROWTH IN 1977 AND THE PICTURE IS NOT LIKELY TO IMPROVE SIGNIFICANTLY THIS YEAR. IMPORTANT HINDERANCE TO INVESTMENT IN PLANT AND EQUIPMENT CONTINUES TO BE SUBSTANTIAL DEGREE OF EXCESS PRODUCTIVE CAPACITY. VARIOUS MEASURES OF CAPACITY UTILIZATION (STATCAN, IT&C, BANK OF CANADA) PRODUCE DIFFERING ESTIMATES OF LEVEL OF CAPACITY UTILIZATION, BUT CONSISTENTLY SHOW SIMILAR CHANGES IN UTILIZATION RATES. ALL MEASURES SHOW INCREASE IN EXCESS CAPACITY IN THIRD QUARTER OF 1977 FAR BELOW PAST PEAKS. MOREOVER, CONTINUING NEAR STAGNATION OF INDUSTRIAL PRODUCTION INDICATES THAT EXCESS CAPACITY MAY STILL BE INCREASING, OR AT LEAST NOT FALLING. FOURTH QUARTER CONFERENCE BOARD SURVEY OF BUSINESS ATTITUDES IDENTIFIES INSUFFICIENT DOMESTIC DEMAND AS MAIN REASON FOR FLAGGING INVESTMENT SPENDING.

8. EXPECTED, RISK-ADJUSTED RATE OF RETURN ON CAPITAL INVESTMENT, A FUNDAMENTAL DETERMINANT OF INVESTMENT SPENDING, IS NOT LIKELY TO MOVE IN SUCH A WAY AS TO STIMULATE INVESTMENT IN 1978. CORPORATE PROFITS HAVE NOT SHOWN SUSTAINED GROWTH. AFTER A STRONG INCREASE IN FIRST QUARTER OF 1977, PROFITS FELL IN THE SECOND QUARTER. WHILE RECOVERY TOOK PLACE IN THIRD QUARTER, PROFITS REMAINED BELOW FIRST QUARTER LEVELS, ARE LOW FOR EARLY PHASE OF EXPANSION IN BUSINESS CYCLE, AND LOW BY HISTORICAL MEASURES.

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EXCEPT FOR INDUSTRIES BENEFITTING FROM CURRENCY DEPRECIATION
AND STRONG FOREIGN DEMAND, THERE IS LITTLE BASIS FOR FIRMS
TO EXPECT SIGNIFICANT IMPROVEMENT IN GROWTH OF PROFITS.
MOREOVER, AS NOTED ABOVE, FIRMS DO NOT EXPECT STRENGTH IN
FUTURE GROWTH OF DEMAND.

9. UNCERTAINTY CLOUDS THE OUTLOOK FOR 1978. MAIN UNCER-
TAINITIES INCLUDE (A) POSSIBLE ACCELERATION OF WAGES AND
COSTS WHEN DECONTROL BEGINS (WHILE SUBSTANTIAL PROPORTION
OF LABOR WILL REMAIN UNDER CONTROLS THIS YEAR, LABOR WILL
EMERGE FROM CONTROLS MORE QUICKLY THAN WILL BUSINESS);
(B) CONTINUING NATIONAL DEBATE RE. "INDUSTRIAL STRATEGY"
AND IMPACT ON VARIOUS SECTORS OF POSSIBLE TARIFF AND NTB
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REDUCTIONS IN MTN; (C) POLITICAL/ECONOMIC UNCERTAINTIES
CONCERNING FUTURE STATUS OF QUEBEC. CONSEQUENTLY, IMPORTANT
ELEMENT OF RISK WILL INCREASE REQUIRED RATE OF RETURN ON
INVESTMENT.

10. LATEST (NOVEMBER) 1977 SURVEY OF INVESTMENT INTENTIONS (SEE OTTAWA 9909) PUBLISHED BY IT&C, INDICATES THAT RELATIVE HIATUS IN ENERGY INVESTMENT COULD OCCUR IN 1978 DUE TO COMPLETION LAST YEAR OF SOME MAJOR PROJECTS. DEPRESSED STATE OF NICKEL AND OTHER MINERAL MARKETS WILL NOT INDUCE NEW INVESTMENT IN MINING SECTOR.

11. IT&C SURVEY IMPLIES THAT REAL NON-RESIDENTIAL INVESTMENT SPENDING WILL STAGNATE THIS YEAR. SURVEY MAY BE SOMEWHAT PESSIMISTIC AND APPEARS INCONSISTENT IN PROJECTING DECELERATION OF MANUFACTURING INVESTMENT IN 1978 COMPARED WITH 1977 AS DEMAND SHOULD BE RELATIVELY STRONGER THIS YEAR THAN LAST. CONFERENCE BOARD HAD FORECAST OPTIMISTIC 6.7 PERCENT GROWTH OF REAL PLANT AND EQUIPMENT INVESTMENT THIS YEAR, BUT REVISED ITS FORECAST DOWN TO 3.5 PERCENT IN DECEMBER FORECAST. IN VIEW OF LOW CAPACITY UTILIZATION RATES, LOW PROFITS AND EXPECTED RATES OF RETURN, AND LOW STATE OF CONFIDENCE, EMBASSY WOULD PLACE INCREASE IN PRIVATE REAL NON-RESIDENTIAL FIXED INVESTMENT ONLY AT ABOUT 1.5 - 2 PERCENT FOR THIS YEAR DESPITE PLETHORA OF INVESTMENT INCENTIVES IMPLEMENTED BY GOC.

12. RESIDENTIAL CONSTRUCTION. WITH EXCEPTION OF SPURT IN HOUSING STARTS IN DECEMBER, RECENT INDICATORS OF CONSTRUCTION ACTIVITY (VALUE OF NEW CONTRACTS, BUILDING PERMITS, HOUSING STARTS) HAVE ALL BEEN WEAK IMPLYING THAT EXCESS SUPPLY OF HOUSING HAS NOT BEEN WORKED OFF AND CONTINUES TO DEPRESS MARKET. THUS, WHILE MOST FORECASTERS HAD EXPECTED LIMITED OFFICIAL USE

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TED HOUSING STARTS TO AVERAGE OVER 245,000 NEXT YEAR, STARTS IN 230,000 - 235,000 RANGE ARE MORE LIKELY. THIS WOULD IMPLY STAGNATION OF RESIDENTIAL CONSTRUCTION EXPENDITURE IN 1978.

13. INVENTORIES. HISTORICALLY, RATIO OF OWNED INVENTORIES TO SHIPMENTS IN MANUFACTURING HAVE AVERAGED ABOUT 2.0. IN FIRST HALF OF 1977, RATIO STAYED BELOW 2; THUS, SWITCH IN INVENTORY ACCUMULATION IN THIRD QUARTER WAS TO BE EXPECTED. FOURTH QUARTER CONFERENCE BOARD SURVEY INDICATES THAT MAJOR FIRMS SEE CURRENT RATIO OF INVENTORIES TO FINAL SALES AS BEING "ABOUT RIGHT". CONSEQUENTLY, INVENTORIES SHOULD GROW IN LINE WITH FINAL DEMAND THIS YEAR. INVENTORY ACCUMULATION SHOULD BE POSITIVE, BUT NOT PARTICULARLY STRONG.

14. ESTIMATES OF THE GROWTH OF THE COMPONENTS OF PRIVATE INVESTMENT PRODUCE AGGREGATE INCREASE OF REAL INVESTMENT OF ABOUT 2 PERCENT FOR 1978.

15. FISCAL POLICY. FEDERAL GOVERNMENT DEFICIT WAS CDOLS

8.5 BILLION AT ANNUAL RATE IN FIRST 8 MONTHS OF FY 1977/78
TUESDAY, MARCH 31, 1978, WITH EXPENDITURES UP 7.6 PERCENT
FROM FY 1976/77 AND REVENUES UP ONLY 0.3 PERCENT. FINAN-
CING REQUIREMENT (I.E. INCLUDING NON-BUDGETARY TRANSACTIONS)
RUNNING AT ANNUAL RATE OF JUST OVER CDOLS 8.0 BILLION; GOC
CONTINUES TO FORECAST FINANCING REQUIREMENT CDOLS 8.5
BILLION FOR ENTIRE FISCAL YEAR. MOST FORECASTS SEE INCREASE
IN DEFICIT AND FINANCING REQUIREMENT IN FY 1978/79, IN PART
DUE TO REDEMPTION OF CDOLS 2.0 BILLION IN CANADA SAVINGS
BONDS SCHEDULED FOR NEXT FALL. ESTIMATES OF FEDERAL GOVERN-
MENT FINANCING REQUIREMENT IN FY 78/79 RUN AS HIGH AS CDOLS
12.0 BILLION.

16. LARGE FEDERAL GOVERNMENT BUDGET DEFICIT PRIMARILY
REFLECTS WEAK GROWTH OF REVENUES RESULTING FROM SLUGGISH
GNP GROWTH. CONFERENCE BOARD ESTIMATES THAT FULL EMPLOYMENT
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SURPLUS (FES) SWUNG TO CDOLS 3.7 BILLION SURPLUS IN CY 1977 AND WILL INCREASE TO SURPLUS OF ABOUT CDOLS 4.7 BILLION IN CY 1978. THUS, STANCE OF FEDERAL GOVERNMENT FISCAL POLICY REMAINS RELATIVELY RESTRICTIVE, CONSISTENT WITH GOC GOAL OF REDUCING INFLATION RATE, AND WILL PROVIDE NO GENERAL STIMULUS TO GNP GROWTH.

17. PROVINCIAL AND LOCAL GOVERNMENTS IN 1977 SOUGHT TO INCREASE CREDITWORTHINESS AND REDUCE DEFICITS FROM HIGH LEVELS SUSTAINED IN 1975-76 AND THEY REMAIN CAUTIOUS. PROVINCES CONTINUE TO INSIST THAT ADDITIONAL FISCAL STIMULUS (E.G., CUT IN SALES TAXES) BE FUNDED BY FEDERAL GOVERNMENT. SPENDING BY JUNIOR GOVERNMENTS SHOULD NOT BE EXPECTED TO GIVE MUCH IMPETUS TO GROWTH THIS YEAR.

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TED TO GIVE MUCH IMPETUS TO GROWTH THIS YEAR.

18. REAL GOVERNMENT SPENDING ON GOODS AND SERVICES IS CURRENTLY RISING AT ANNUAL RATE OF LESS THAN 2 PERCENT, I.E., LESS THAN REAL GNP GROWTH. THERE ARE NOT YET INDICATIONS THAT RATE OF SPENDING WILL INCREASE OVER THE NEXT TWELVE MONTHS. MAIN UNCERTAINTY IN ESTIMATING GOVERNMENT SPENDING IS SHAPE OF SPRING FEDERAL BUDGET WHICH DEPENDS COURSE OF ECONOMY IN EARLY 1978. SHOULD ECONOMY CONTINUE TO BUMP ALONG, GOC MAY DECIDE TO STIMULATE CONSUMPTION AS CONCRETE DEMONSTRATION OF ITS CONCERN ABOUT THE ECONOMY PRIOR TO ELECTIONS IN SPRING OR EARLY SUMMER.

19. MONETARY POLICY. STATED GOAL OF GOC MONETARY IS TO INDUCE PROGRESSIVE REDUCTION IN INFLATION RATE OVER MEDIUM TERM THROUGH SUCCESSIVE LOWERING OF M1 GROWTH, WHILE ACCOMMODATING A RATE OF ECONOMIC EXPANSION WHICH IS CONSISTENT WITH FULLER UTILIZATION OF RESOURCES AND LOWER UNEMPLOYMENT. THE TARGET RATE OF GROWTH OF M1 HAS BEEN LOWERED THREE TIMES SINCE 1975 AND IS NOW SEVEN TO ELEVEN PERCENT ANNUAL RATE FROM A BASE OF JUNE 1977. IN FACT, WHILE MAINTAINING MODERATE GROWTH OF MONETARY AGGREGATES, THE BANK OF CANADA IN 1977 APPEARS TO HAVE MAINTAINED AN INTEREST RATE STRUCTURE WHICH IS LOW ENOUGH TO BE CONSISTENT WITH HIGHER RATES OF INVESTMENT AND HIGH ENOUGH TO AVOID FURTHER MAJOR DEPRECIATION OF THE CANADIAN DOLLAR.

20. AN UPWARD TREND IN U.S. INTEREST RATES, COMBINED WITH POSSIBLE GOC DESIRE TO AVOID FURTHER DOLLAR DEPRECIATION COULD RESULT IN FALL OF M1 GROWTH BELOW TARGET RANGES.

THIS SCENARIO IS CONSIDERED THE MOST LIKELY BY MOST PRIVATE
FORECASTERS. EMBASSY INCLINED TO AGREE.
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21. PRICES. CONSUMER PRICES ACCELERATED SUBSTANTIALLY DURING COURSE OF 1977. ACCELERATION DUE LARGELY TO SHARP INCREASES IN FOOD PRICES WHICH IN TURN WAS INFLUENCED BY DEPRECIATION OF CANADIAN DOLLAR. TWELVE MONTH INCREASE (NON-SEASONALLY ADJUSTED) IN FOOD PRICES WAS LESS THAN 1 PERCENT IN JANUARY 1977 BUT REGISTERED 12 MONTH INCREASE OF NEARLY 16 PERCENT IN NOVEMBER. IN CONTRAST, NON-SEASONALLY ADJUSTED INCREASE IN NON-FOOD PRICE INCREASE DECELERATED FROM 12 MONTH INCREASE OF 8.2 PERCENT IN JANUARY TO 7.4 PERCENT IN NOVEMBER. TREND IN NON-FOOD PRICE INDEX INDICATES THAT RATE OF INCREASE IN UNDERLYING INFLATION RATE DECLINED DURING YEAR, A CONCLUSION CONSISTENT WITH DECELERATION OF UNIT LABOR COST INCREASES OVER THE YEAR.

22. BECAUSE MOVEMENT FOOD PRICES DOMINATED THAT OF NON-FOOD PRICES LEADING ACCELERATION OF OVERALL CPI, CONSUMER PRICES AT END OF 1977 COULD STAND ABOUT 4 PERCENT ABOVE AVERAGE FOR 1977 AS A WHOLE. THUS, EVEN IF NO PRICE INCREASES WERE TO OCCUR DURING COURSE OF 1978, AVERAGE INFLATION RATE FOR THIS YEAR WOULD FINISH 4 PERCENT ABOVE AVERAGE 1977 LEVEL. ORIGINAL GOC TARGET OF 6 PERCENT AVERAGE INFLATION RATE IN 1978 IS CLEARLY NOT ATTAINABLE SINCE THIS WOULD REQUIRE PRICE INCREASE OF ONLY 5 PERCENT BETWEEN DECEMBER 1977 AND DECEMBER 1978. UNOFFICIAL GOC TARGET IS NOW 6 PERCENT PRICE INCREASE BETWEEN FOURTH QUARTERS OF 1977 AND 1978. IF THIS GOAL IS ATTAINED, AVERAGE INFLATION RATE FOR NEXT YEAR WOULD BE ABOUT 7.0 PERCENT.

23. FOOD PRICES CONTINUED TO RISE RAPIDLY IN NOVEMBER. HOWEVER, AIB'S FOOD PRICE INDEX MODERATED IN DECEMBER AND GOVERNMENT AND PRIVATE FORECASTS EXPECT PRICES TO MODERATE FURTHER DURING 1978. ABSENT FURTHER DEPRECIATION IN CANADIAN DOLLAR, THIS SHOULD BE THE CASE.

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24. UNIT LABOR COSTS SHOULD CONTINUE TO MODERATE AS WELL. INCREASES IN NOMINAL COMPENSATION ARE LIKELY TO BE CLOSE TO GOC 6 PERCENT CEILING DUE TO OPERATION OF CONTROLS PROGRAM AND CONTINUED WEAK DEMAND FOR LABOR. NOMINAL COMPENSATION INCREASES COULD ACCELERATE SOMEWHAT AS DECONTROL PROCEEDS BUT WEAK DEMAND, GRADUAL NATURE OF PHASEOUT AND (HOPEFULLY) MODERATION OF OTHER CPI COMPONENTS SHOULD KEEP LID ON COMPENSATION INCREASES. THUS INCREASE COMPENSATION SHOULD FALL FROM PRESENT RATE OF 7.6 PERCENT TO ABOUT 6.5 PERCENT ON AVERAGE FOR NEXT YEAR, WITH RISE IN AVERAGE EARNINGS FALLING FROM 10 PERCENT TO ABOUT 8 PERCENT.

25. TREND RISE IN PRODUCTIVITY IN CANADIAN ECONOMY IS ABOUT
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2.3 PERCENT. SINCE REAL GNP GROWTH IS LIKELY TO BE CLOSE TO OR BELOW GROWTH OF PRODUCTIVITY CAPACITY (4.5 - 5 PERCENT) GROWTH OF PRODUCTIVITY WILL PROBABLY BE BELOW TREND

INCREASE - 2 PERCENT OR SLIGHTLY HIGHER. AS A RESULT, AVERAGE RISE IN UNIT LABOR COSTS WILL BE ABOUT 6 PERCENT ON AVERAGE IN 1978 WITH DECELERATION OCCURRING DURING THE YEAR.

26. UNDERLYING RATE OF INFLATION, AS MEASURED BY INCREASE IN NON-FOOD PRICES, CAN BE EXPECTED TO RISE MORE RAPIDLY THAN UNIT LABOR COSTS. ADMINISTERED INCREASE OF ONE DOLLAR PER BARREL CRUDE OIL PRICES ON JANUARY 1 WILL COME THROUGH TO RETAIL LEVEL IN MARCH. ADDITIONAL ONE DOLLAR INCREASE COULD TAKE PLACE ON JULY 1. GOC HAS AUTHORITY TO IMPOSE LEVY OF UP TO ONE DOLLAR PER BARREL ON CRUDE OIL TO HELP FINANCE SUBSIDIZATION OF OIL PRODUCTION FROM ALBERTA TAR SANDS. INFLATIONARY IMPACT OF LEVY DEPENDS ON TIMING AND ON DEGREE TO WHICH GOC USES MAXIMUM AUTHORITY. THERE WILL ALSO BE LINGERING INFLATIONARY EFFECTS OF DEPRECIATION. PROBABILITY IS LOW THAT PRICE INCREASES DURING COURSE OF 1978 CAN BE HELD TO 6 PERCENT TARGETTED BY GOC AND AVERAGE RISE IN CPI COULD WELL APPROACH 7.5 PERCENT.

27. RISE IN IMPLICIT GNP DEFLATOR HAS BEEN SLOWER THAN THAT OF CPI DURING 1977, HAS SHOWN IRREGULAR PATTERN DURING YEAR. GNP DEFLATOR IN FOURTH QUARTER COULD STAND 3 PERCENT ABOVE AVERAGE LEVEL FOR YEAR AND SHOULD INCREASE BY 6.5 PERCENT ON AVERAGE IN 1978.

28. UNEMPLOYMENT. GROWTH OF EMPLOYMENT DURING 1977 AVERAGED ABOUT 1.9 PERCENT COMPARED WITH 2.9 PERCENT INCREASE IN LABOR FORCE. HENCE UNEMPLOYMENT RATE ROSE PROGRESSIVELY DURING YEAR REACHING 8.5 PERCENT IN DECEMBER. WITH AN INCREASE OF ABOUT 4 PERCENT IN REAL GNP IN 1978
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TOTAL EMPLOYMENT SHOULD RISE BY 2 - 2.5 PERCENT (SEE OTTAWA 155). LABOR FORCE IS EXPECTED TO INCREASE BY ABOUT SAME AMOUNT (ASSUMING NO FURTHER RISE IN PARTICIPATION RATE) WITH RESULT THAT UNEMPLOYMENT RATE WILL NOT FALL SUBSTANTIALLY FROM PRESENT LEVEL. HOWEVER, PARTICIPATION RATE INCREASED BY 0.4 TO 61.5 PERCENT IN 1977. IF SIMILAR RISE TAKES PLACE IN 1978, AVERAGE UNEMPLOYMENT RATE FOR YEAR WOULD RISE TO 8.7 PERCENT.

29. FORECAST RISKS. THE MAIN RISK FOR 1978 IS POSSIBILITY OF ACCELERATION OF WAGE AND PRICE INCREASES WHEN PHASEOUT OF CONTROLS BEGINS APRIL 14. TO THE EXTENT THAT PRICES CONTINUE TO RISE RAPIDLY IN EARLY 1978 DEPRESSING REAL WAGES, THE POSSIBILITY IS ENHANCED THAT NOMINAL WAGE INCREASES AND PRICE INCREASES WILL ACCELERATE AS DECONTROL PROCEEDS. WEAK DEMAND AND GRADUAL NATURE OF PHASEOUT TEND TO MINIMIZE THIS RISK. CANADIAN LABOR CONGRESS HAS INDICATED THAT LABOR IS "REALISTIC" AND WILL NOT SEEK EXCESSIVE

WAGE INCREASES WITH PASSING OF CONTROLS. HOWEVER, IF "STRUGGLE FOR INCOME SHARES" DOES MATERIALIZE, BUSINESS WILL PROBABLY LOSE, SINCE UNDER DECONTROL SCHEDULE LABOR EMERGES FROM CONTROLS MORE RAPIDLY THAN DOES BUSINESS. RESULT WOULD THUS BE SLOWER GROWTH OF PROFITS, DEPRESSED BUSINESS CONFIDENCE, WEAKER INVESTMENT SPENDING, AND FASTER GROWTH OF REAL CONSUMPTION THAN SHOWN IN EMBASSY FORECAST. IMPROVEMENT IN CANADIAN COMPETITIVE POSITION WOULD BE REVERSED IN ABSENCE FURTHER EXCHANGE RATE DEPRECIATION WITH THE EXPECTED EFFECTS ON TRADE AND CURRENT ACCOUNT BALANCES.

30. A SIGNIFICANT SLOWDOWN IN U.S. GNP GROWTH WOULD ALSO HAVE MAJOR ADVERSE EFFECT ON CANADA. CANADA WOULD THEN BE FACED WITH WIDENING CURRENT ACCOUNT DEFICIT AND SLOWER GROWTH COMING AT TIME WHEN UNEMPLOYMENT RATE WOULD ALREADY BE IN EXCESS OF 8 PERCENT.

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NSC-05 TRSE-00 SS-15 STR-06 OMB-01 CEA-01 CIAE-00
COME-00 FRB-03 INR-07 NSAE-00 XMB-02 OPIC-03
LAB-04 SIL-01 IGA-02 DODE-00 PM-05 H-01 L-03
PA-01 PRS-01 DOE-11 SOE-02 INT-05 AGRE-00 HUD-01
/124 W

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P 172358Z JAN 78

FM AMEMBASSY OTTAWA

TO SECSTATE WASHDC PRIORITY 6003

INFO AMEMBASSY BONN

AMEMBASSY BRUSSELS

AMEMBASSY LONDON

AMEMBASSY PARIS

AMEMBASSY ROME

AMEMBASSY TOKYO

AMCONSUL MONTREAL
ALL OTHER CONGENS IN CANADA (POUCH)

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31. THERE IS ALSO A RISK THAT REAL GNP GROWTH WILL BE SLOWER THAN FORECAST DUE TO INVESTMENT SPENDING'S BEING EVEN WEAKER THAN PROJECTED. THE MAJOR FACTOR GENERATING SUCH A RESULT WOULD BE POLITICAL/ECONOMIC UNCERTAINTY, WITH HIGH INFLATION AND RISING INTEREST RATES PLAYING SUPPORTING ROLES.

32. CURRENT ACCOUNT. EMBASSY ASSESSMENT OF CURRENT ACCOUNT OUTLOOK FOR 1978 HAS NOT CHANGED GREATLY FROM LAST DETAILED ASSESSMENT (OTTAWA 9569 DATED NOV. 5). GROWING MERCHANDISE SURPLUS IN 1977 WAS MORE THAN OFFSET BY GROWTH OF SERVICE DEFICIT AND WE EXPECT THESE TRENDS WILL CONTINUE INTO 1978. CURRENT ACCOUNT BALANCE IS EXPECTED TO SHOW
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SOME DETERIORATION FROM CDOLS 4.4 BILLION
DEFICIT EXPECTED FOR 1977.

33. MERCHANDISE TRADE. ON ASSUMPTION 1978 U.S. REAL GNP WILL GROW 4.5 PERCENT AND CANADIAN DOLLAR DOES NOT FURTHER DEPRECIATE, REAL EXPORTS SHOULD INCREASE ABOUT 5 PERCENT AND IMPORTS 3.5 TO FOUR PERCENT. EXPORT AND IMPORT PRICES SHOULD GROW ABOUT 7 AND 8 PERCENT RESPECTIVELY, GENERATING A MERCHANDISE TRADE SURPLUS OF NEARLY CDOLS 3.5 BILLION, UP FROM ABOUT CDOLS 2.7 BILLION EXPECTED FOR 1977. UPWARD REVISIONS OF U.S. THIRD QUARTER REAL GNP GROWTH AND OCTOBER SLIDE OF CANADIAN DOLLAR COULD HELP CANADIAN TRADE BALANCE THIS YEAR AND NEXT, BUT COULD BE PARTIALLY OFFSET BY RECENT SOFTNESS OF AUTO SALES IN U.S. AND LEVELLING OFF OF U.S. HOUSING STARTS.

34. TRAVEL DEFICIT. THE HUGE TRAVEL DEFICIT WILL GROW LESS RAPIDLY IN 1978 DUE TO CANADIAN DOLLAR DEPRECIATION, BUT WILL STILL APPROACH CDOLS 2 BILLION, UP FROM ABOUT 1.7 BILLION THIS YEAR.

35. PRELIMINARY FIGURES SHOW THAT THE ABSOLUTE NUMBER OF CANADIAN VISITS ABROAD DECLINED SLIGHTLY IN SOME MONTHS THIS FALL, INDICATING THAT THE CANADIAN DOLLAR DEPRECIATION IS FINALLY BEGINNING TO BITE A BIT ON VOLUME OF TRAVEL ABROAD, BUT WE EXPECT TOTAL SPENDING WILL NOT DECLINE BUT EDGE UP A BIT. EFFORTS TO ENCOURAGE TOURISM WITHIN CANADA SO FAR HAVE BEEN DISSULTORY. ONLY THE MOST TIMID STEPS HAVE BEEN TAKEN FOR EXAMPLE, TOWARDS MORE COMPETITIVE

PRICING ON DOMESTIC CHARTER FLIGHTS.

36. INTEREST AND DIVIDENDS. NET PAYMENTS ABROAD FOR
SERVICING OF DEBT AND EQUITY WILL CONTINUE TO RISE. WHILE
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THE AMOUNT OF NET NEW BOND ISSUES ABROAD IN 1977 DECLINED
FROM THE HISTORIC HIGH LEVELS OF 1976, INCREASES IN OTHER
FORMS OF LONG TERM DEBT, NOTABLY CONSORTIUM BANK LOANS
SUCH AS THE RECENT U.S. DOLS 750 MILLION TEN YEAR BORROWING
BY HYDRO QUEBEC WILL BRING TOTAL NET NEW BORROWING ABROAD
IN 1977 UP TO ABOUT U.S. DOLS 5 BILLION. SOME FURTHER
INCREASE CAN BE EXPECTED IN 1978. DIVIDEND PAYMENTS ABROAD
IN CALENDAR YEAR 1978 ARE EXPECTED TO INCREASE AS ANTI-
INFLATION BOARD RESTRICTIONS ON DIVIDEND INCREASES ARE
REMOVED. THE NET OUTFLOW OF INTEREST AND DIVIDENDS IS THUS
STILL EXPECTED TO BE NEARLY CDOLS 3.4 BILLION IN 1977 AND
4 BILLION IN 1978.

37. TABLES

ANNUAL AVERAGE PERCENT CHANGE, YEAR OVER YEAR

-----1977-----1978

GNP-----2.4-----4.0

FINAL DEMAND-----2.4-----3.6

UNEMPLOYMENT RATE---8.1-----8.5

CPI-----8.0-----7.5

GNP DEFLATOR-----6.7-----6.5

CURRENT ACCOUNT, BILLIONS OF CURRENT CANADIAN DOLLARS
BRACKETS INDICATE DEFICIT

MERCHANDISE TRADE---2.7-----3.4

SERVICE BALANCE----(7.5)----- (8.7)

OF WHICH

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--INTERESTS AND

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AMCONSUL MONTREAL
ALL OTHER CONGENS IN CANADA (POUCH)

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DIVIDENDS------(3.4)------(4.1)

--TRAVEL------(1.8)------(2.0)

BALANCE OF
GOODS AND SERVICES (4.8)------(5.3)

CURRENT ACCOUNT
BALANCE------(4.4)------(4.9)
ENDERS

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